HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

14 February 2012

Mervyn King
Governor
The Bank of England
Threadneedle Street
London
EC2R 8AH

Dear Mervyn,

CPI INFLATION

Thank you for your letter of 13 February on behalf of the Monetary Policy Committee (MPC) regarding the CPI inflation rate of 3.6 per cent in January, written under the terms of the MPC's remit.

Inflation has now fallen markedly from its peak of 5.2 per cent in September 2011. The further fall in the latest CPI figure was expected, as the impact of the increase in VAT in January 2011 dropped out of the twelve-month comparison.

I note the explanation in your letter that inflation will fall further on the basis of declining contributions from petrol prices and any remaining VAT impact, together with recently-announced cuts to domestic energy prices. The impact of past rises in energy and import prices is also expected to dissipate, and it is the MPC's best collective judgement that CPI inflation will continue to fall back to around the target rate of 2.0 per cent by the end of 2012. I understand that the pace and extent of the fall in inflation remains subject to uncertainty, and that heightened tensions in oil-exporting countries pose the risk of further external price shocks.

I welcome the MPC's continued determination to set policy to ensure that inflation is on track to meet the target in the medium term. As the MPC noted at its February meeting, while some recent business surveys have painted a more positive picture, the pace of expansion in the UK's main export markets have slowed. The MPC judged, with external price pressures diminishing, and the underlying weakness in domestically-generated inflation likely to persist, that without further monetary stimulus, it was more likely than not that inflation would undershoot the 2 per cent target in the medium term. This is why I authorised the increase in the ceiling of asset purchases financed by the issuance of central bank reserves from £275 billion to up to £325 billion.

You have explained that the combination of sluggish growth and high inflation over the past two years is a reflection of the need for the economy to rebalance following the financial crisis and associated deep recession, together with rises in the costs of energy and imports. Although inflation is now falling broadly as expected, the process of rebalancing has a long way to go. I note and agree with this analysis.

As I have made clear in the past, monetary policy has a critical role in supporting this rebalancing. It is the first line of defence in the face of economic shocks. But the Government's absolute commitment to reducing our record budget deficit and getting the public finances back on to a sustainable path allows monetary policy to stay looser for longer, providing a monetary stimulus to the economy at a time of fiscal consolidation. This would have been harder to achieve without a credible plan for dealing with our debts.

I am copying this letter to the Chairman of the Treasury Committee and depositing this letter immediately in the libraries of both Houses and on the Treasury website.

Best wishes,

GEORGE OSBORNE